Spurred Investment?

Also finds that safe-harbor leasing provides an incentive for steady longer-term growth and profitability. Safe harbor enables such firms, especially hard-pressed manufacturers such as automobile and steel, to avoid cutting or postponing investment in capital equipment. These additional investments would immediately raise the profits of other firms. Because the trough in investment spending often lags the trough in general economic activity, sluggish investment tends to retard recoveries. If safe harbor leasing had continued, it might not have altered this lag; yet, it might have provided significant countercyclical advantages in limiting the depth of a downturn. Safe-harbor benefits might not be sufficient to encourage investment in additional capital equipment during recessions, but they should help firms maintain investment in replacement capital.

Although safe-harbor leasing seems to be a dead issue, the concept is likely to re-emerge in the future when business activity again weakens and the federal budget deficit does not present its current constraints. Economists and legislators might consider alternatives to safe-harbor leasing that would preserve its useful elements while correcting its faults. Indeed, why discard the wheat with the chaff?

Separating the Wheat from the Chaff

In August 1981 the U.S. Congress enacted the Economic Recovery Tax Act (ERTA) to stimulate investment in plants and equipment through lower depreciation tax credits and a more rapid method of depreciation. Before this legislation, firms that did not generate sufficient taxable income to be able to benefit equally? Should the tax code be available to all firms? 6

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NOTES: No issues of the Economic Commentary were published in August or September.


2. Firms that participate in these tax-benefit sales tax-free from IRS prosecution—hence, the term tax-free. See Verpepe, "The Assault on 'Safe Harbor' Leasing."
The Mechanics

Safe-harbor leasing permits financial transactions in which firms with insufficient taxable income sell tax benefits to more profitable firms. In a typical safe-harbor lease, a firm with little or no profit— the seller—sells its newly acquired capital equipment to a profitable firm—the buyer—with income in excess of its allowable tax credits and deductions. The seller receives a cash payment plus a note for the balance of the value of the property but retains possession of the capital, which is now leased from the buyer. This transaction is called a leaseback. As nominal owner of the property, the buyer claims the accelerated cost recovery system (ACRS) deductions and the investment tax credit for the property. The seller incurs an annual rental fee for use of the property but recovers the investment tax credits and personal credits on the purchaser’s note. In most safe-leaseback leases, the rental and debt charges are equal so that no money except the initial cash payment is actually exchanged between buyer and seller. The equal rental and debt payments are said to wash, and these transactions are called wash leases.

The initial cash payment is effectively a payment from the buyer to the seller for the tax benefits associated with the capital equipment. It equals the share of the current value of these benefits going to the seller as negotiated between the two firms. The payment improves the cash flow of the seller firm, possibly avoiding layoffs and delaying cuts in investment projects.

Revenue Impact

The congressional decision to scale down and eventually stop safe-harbor leasing occurred at a time when the administration was attempting to reduce huge budget deficits (see chart 1). Opponents of safe-harbor leasing argue that the program’s provisions cause an unnecessary revenue drain. The purpose of leasing the capital equipment is to reduce the capital’s value. Without any change in the safe-harbor leasing program, both the Joint Committee on Taxation and the Treasury estimate that resultant net losses to the Treasury would grow from $3.2 billion in fiscal year (FY) 1982 to approximately $9.5 billion in FY 1986. Using Congressional Budget Office estimates of the federal budget deficit, the revenue loss would equal 2.9 percent of the deficit in FY 1982 and 4.7 percent in FY 1985. According to administration budget estimates, the loss could grow to 20 percent of the deficit by FY 1991.

As both the Treasury and the Joint Committee on Taxation observe, such revenue losses are very difficult to measure. Recent changes in the investment tax credit and the method of calculating depreciation deductions, together with the sharp decline in business activity, greatly complicate the task of isolating the impact of safe harbor on revenues. The above figures represent the net revenue loss to the Treasury. They attempt to measure directly the tax reduction gained by firms using the tax incentive and to account indirectly for additional tax generated from the firms producing and selling equipment. The exercise in the calculations is as important as the former element, but it is also the most difficult to measure accurately. Other factors also account for the rapid rise in estimated revenue losses through FY 1987. Because safe-harbor leasing is a new type of financial arrangement, it would have become more popular as it became better known. The revenue-loss projections assume that, with depreciation allowances accelerating in 1981, 1985, and 1986, more firms would sell the deductions, resulting in additional tax revenue losses. There are also some build-up in tax write-offs, because tax credits and depreciation allowances in 1983 are made for equipment purchased in 1981, 1982, and 1981; deductions in 1984 are made for equipment purchased in 1984, 1983, and 1982. Safe-harbor leasing results in a large revenue loss at a time when the federal budget can scarcely afford it, and when the projected financial requirements of the federal budget deficit threaten to keep direct tax increases on the table. The absence of safe-harbor leasing would be no corresponding revenue loss; but, any non-revenue benefits also would be foregone. The evaluation of safe-harbor leasing should rest on a comparison of the costs and benefits, although these may be difficult to measure.

The Matter of Targeting

A frequent criticism of safe-harbor leasing is that the program is not well targeted. In large part, the targeting criticism centers on the complaint that the seller of the capital equipment benefits less than the full value of that tax break. Both the Joint Committee on Taxation and the Treasury Department have attempted to determine what percentage of the tax break accrues to the seller, the buyer, and the third parties (lenders and investment bankers) who arranged the transaction. Largely because of differences in estimation techniques, the Treasury’s estimate of the share of tax benefits accruing to the seller is greater than the Joint Committee’s.4 Both estimates, however, follow the same trend. The Treasury finds that 84.5 percent of the tax break goes to the seller and 15.5 percent to the buyer and third parties. The Joint Committee finds that 76.5 percent of the break goes to the seller, 21.5 percent to the buyer, and 2 percent to third parties. In addition to the above, there show the lion’s share of the tax benefits accrues to those firms that otherwise had insufficient income to benefit from the investment tax credits contained in the corporate tax code; they also showed that profitable, tax-paying firms received a hefty share of the benefits to become involved. The safe-harbor provisions allow one firm to sell its tax benefits to another. By its very nature, the transaction implies that both parties would benefit. The share received by the buyer, interestingly, should correspond to the finance charge that a bank might assess on a loan. The buyer, after all, is providing financial capital to the seller; a 15 percent to 22 percent fee does not seem unusual given the high interest rates of recent years. The fee accruing to the middlemen is similar to fees paid to third parties in most other financial transactions.

A second targeting criticism is that the program has provided one more loophole through which profitable firms can avoid paying corporate income taxes. Indeed, there has been instances in which profitable firms have purchased enough tax breaks to eliminate their corporate tax liability completely, and cases where profitable firms generated tax reductions in excess of their tax liabilities and sold the excess tax credits. In its June 1982 report on safe-harbor leasing, the Joint Committee on Taxation presents data indicating that profitable industries, such as oil and gas, chemicals, and utilities, have received hefty benefits from safe-harbor leasing; however, the data also show that many less profitable industries also have been helped, including forest products, railroads, ferrous metals, and automobiles (see table 2). According to the Treasury,